Journal of Financial Economics
Volume 9, Issue 1, March 1981, Pages 19-46

Misspecification of capital asset pricing: Empirical anomalies based on earnings' yields and market values

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https://doi.org/10.1016/0304-405X(81)90019-2

Abstract

This study documents empirical anomalies which suggest that either the simple one-period capital asset pricing model (CAPM) is misspecified or that capital markets are inefficient. In particular, portfolios based on firm size or earnings/price (*E/P*) ratios experience average returns systematically different from those predicted by the CAPM. Furthermore, the ‘abnormal’ returns persist for at least two years. This persistence reduces the likelihood that these results are being generated by a market inefficiency. Rather, the evidence seems to indicate that the equilibrium pricing model is misspecified. However, the data also reveals that an *E/P* effect does not emerge after returns are controlled for the firm size effect; the firm size effect largely subsumes the *E/P* effect. Thus, while the *E/P* anomaly and value anomaly exist when each variable is considered separately, the two anomalies seem to be related to the same set of missing factors, and these factors appear to be more closely associated with firm size than *E/P* ratios.

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* I wish to thank my Ph.D. Committee — Eugene Fama, Jack Gould, Robert Hamada, Jon Ingersoll, Roger Kormendi, and Myron Scholes — as well as David F. DeRosa, Michael Gibbons, Pat Hess, Bill Schwert, Rob Stambaugh, and Ross Watts for their helpful comments and suggestions. Partial financial support for this research was provided by the University of Chicago's Center for Research in Security Prices and the Graduate School of Business. Naturally, all errors are my responsibility.

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